Summary of Discussion Points

Presented by the Business and Industry Advisory Committee (BIAC) to the OECD Competition Committee’s Working Party No. 3

"Economic Evidence in Merger Analysis"

February 15, 2011

1. Introduction
   1. The Business and Industry Advisory Committee to the OECD (BIAC) on the issues identified for discussion in the OECD’s Working Party roundtable discussion on “economic evidence in merger analysis” scheduled for 15 February 2011.

   2. The paper focuses on three core areas identified within the invitation to comment which have the potential to impact most significantly on the business community;
      a. UPP analysis of unilateral effects in horizontal mergers;
      b. Developments in the analysis of vertical mergers; and;
      c. The treatment of efficiencies in merger cases.

   3. Throughout the paper, a number of conclusions are highlighted which serve to indicate the preferences of BIAC when it comes to the application of evidence and the choice of techniques employed by Competition Authorities. The general principles underlying these conclusions can be summarised as follows:
      a. avoid the application of techniques which increase the prospect of type I and type II errors and the degree of uncertainty for merging firms;
      b. consider evidence ‘in the round’ and do not rely unduly on specific indicators (such as for example diversion ratios and margins) which are subject to measurement error;
      c. when determining safe harbour thresholds guard against introducing an unnecessarily interventionist standard for merger screening and avoid capturing mergers very unlikely to result in anti competitive effects; and
d. be open to credible evidence pertaining to a range of factors including pro-competitive efficiencies.

2. UPP analysis of unilateral effects in horizontal mergers

2.1. Introduction

4. Upwards Pricing Pressure (‘UPP’) methods outlined in the US merger guidelines can be of significant value to Competition Authorities as a tool for merger analysis. In particular, these techniques incorporate measures of the ‘closeness of competition’ between merging firms that are not taken into account within traditional market share based approaches to merger screening.

5. But realising these potential benefits depends on the way in which UPP methods are implemented and there are risks in moving away from the traditional tools currently employed by Competition Authorities. These are discussed in more detail below.

2.2. Loss of transparency and useful sense checks if market definition and market share considerations are discarded

6. Traditionally, market definition, and the assessment of market shares, has been used by Competition Authorities as an important screening device to identify those mergers most likely to give rise to potential anti-competitive effects.

7. Whilst UPP methods in principle offer benefits for Competition Authorities seeking to identify those mergers most likely to lead to anticompetitive effects, a significant issue for business and its advisers in implementing these techniques as a merger screen surrounds the availability of the necessary evidence at the pre-notification stage. Specifically, UPP analysis relies on two crucial pieces of economic evidence (diversion ratios and variable margins) and these are by no means widely available or trivial to estimate (see section 2.4). In turn, this can only serve to decrease transparency and predictability over the degree of regulatory risk arising from potential merger activity.

8. BIAC submits that when compared to an analysis of market shares the UPP test will often increase the legal uncertainty for merging firms resulting in fewer efficiency enhancing mergers.

9. More generally, the process of market definition – and in particular gathering informative evidence on the scope for demand and supply side substitution – provides a rigorous and well tested framework for understanding the supply-side and demand-side constraints on merging parties. While this framework can, in theory, also be established via a direct analysis of competitive constraints on the merging parties, in practice the process of market definition provides greater certainty that Competition Authorities will fully consider the broad set of potential competitive constraints, and greater transparency as to the approach used by the Authorities to identify them.

10. **BIAC submits that while diversion ratios can, in theory, provide an initial filter for competition concerns it is vital that the Authorities maintain a balanced overview of all available evidence and check each and every form of evidence against other analyses in order to avoid unrealistic conclusions.**

2.3. **Risk of higher intervention standards**

11. As with any tool used to identify potentially problematic mergers, UPP analysis requires intervention thresholds to be set before any judgement can be made as to which mergers would be considered sufficiently concerning to warrant further investigation.²

12. In line with this, leading economists behind the US merger guidelines have suggested a standard ‘efficiency credit’ of 10% should be applied to all mergers so that those generating UPPs below 10% would not be challenged by the US agencies on the grounds that their anti-competitive tendencies are outweighed by assumed efficiency advantages.³

13. However, where intervention thresholds are set lower than this level, there is a clear implication that the adoption of a UPP-oriented approach to merger screening would result in significantly more cases being subject to a costly second phase merger assessment.⁴ Even more concerning, were these tests to be used as a basis for full blown merger assessment (and there is some evidence from the UK merger regime that they have been) then low thresholds would imply a lower standard for intervention.

14. **BIAC submits that when considering the appropriate thresholds for UPP and IPR analysis Competition Authorities must guard against inadvertently introducing a more interventionist standard for merger screening.**

2.4. **Measurement difficulties**

15. As noted above, UPP techniques require two critical pieces of information: diversion ratios and variable margins. However there are potentially significant difficulties associated with measuring both of these variables which are discussed in turn below.

2.4.1. **Diversion ratios**

16. To estimate the diversion ratio between the two merging firms three main approaches have been advocated: (i) market shares, (ii) consumer surveys and (iii) econometric studies.

² Absent such thresholds, all mergers involving firms in the same market would deliver a positive ‘UPP’.


⁴ This point is illustrated by comparing the outcomes of UPP tests with the more traditional approach of fascia counts. Generally it is not controversial to assume that Competition Authorities have not usually been concerned about mergers that reduce the number of firms in the market from five to four (or above). In a symmetric case in which market demand was always re-distributed between the remaining firms, the diversion ratio expected in such a scenario would be 25%. By way of comparison, the margins required to trigger a finding of positive incentives to raise prices under the UPP formula with a diversion ratio of 25% and an efficiencies credit of 10% is 30%. When the intervention threshold is set at 5%, the level of margins required to warrant a positive outcome of the test falls to 16%. The reality is that at this lower threshold many merging will find that they have sufficiently high variable margins to fall foul of such calculations, leading to larger numbers of in depth investigations.
17. One of the supposed main advantages of UPP and its related screens is to add greater insight than market share based screens alone. Indeed, leading economists originally portrayed the UPP measure as “an economic alternative to market definition”. If the implementation of UPP requires market share information, and therefore a market definition exercise to be undertaken, it is not clear how much of an alternative they are.

18. Consumer surveys have been used in the UK to measure diversion ratios in several cases. The standard question is usually along the lines of: “You purchased product X from store 1. If store 1 had been closed, where would you have purchased product X instead?” However, these questions may well reflect bias or inaccuracy as a result of being stated preferences (i.e. answers to hypothetical questions can be quite different from actual behaviour). Moreover, experience shows that consumers’ responses to these questions can vary significantly depending on the precise way that they are phrased. Put differently, different variations on the same questions can potentially imply significantly different levels of unilateral effects.

19. Another approach in theory to estimating diversion ratios is the use of econometrics. While such techniques may allow analysts to measure diversion ratios more accurately (data permitting), in practice they are not suitable for use in initial screens due to the time and information requirements and have traditionally been highly controversial when applied in previous cases.

20. BIAC submits that, like any other evidence, diversion ratios are subject to measurement errors. High diversion ratios should not therefore form the basis of a structural presumption of anti competitive effects but should instead be reviewed with other evidence in the round.

2.4.2. Margins

21. At the initial filter stage Competition Authorities may consider estimating firms variable margins based on management accounts. However, this approach is rarely justified as variable margins should be measured over the time period in which firms make pricing decisions. These timeframes are rarely likely to coincide with those used to periodically apportion costs from a management accountancy perspective. In summary, the measurement of the relevant margin from accounting data is by no means a straightforward exercise.

22. BIAC submits that management accounts do not form an economically coherent basis for estimating variable margins because they do not correspond to the timeframes of pricing decisions. There are both practical measurement and conceptual questions on the most appropriate margin figures to use that have not yet been satisfactorily resolved, and that make very big differences to the outcome of UPP enquiries.

2.5. Risks associated with “black box” methods that divorce economic analysis from business reality (inc UPP, IPRs, merger simulation)

23. Whilst UPP and other techniques such as Illustrative Price Rise formulas (IPRs) and full blown merger simulation offer potentially significant benefits in terms of their ability to better identify potentially problematic mergers, Competition Authorities should be wary of the spurious precision created by such approaches and certainly should not see them as an alternative to an in depth analysis of merger effects.

24. UPP and IPR formulae are, by their nature, simplified formulations based on a wide range of restrictive assumptions. For example, both models rely on static models of competition to generate predictions on the price effects of mergers (see section 2.6). Moreover, IPRs also require a number of untested assumptions to be made as to the shape of firms’ demand curves. When these apparently simple formulae are amended to take into account the realities of competition they may rapidly become unworkable. Yet failing to modify simple formulae to reflect market realities can lead to unreliable predictions. The UPP model relies on fewer assumptions than the IPR approach. However, its failure to assess the scale of price effects makes it effectively incomplete as a tool for assessing the likely impact of mergers in the context of in depth merger assessment.

25. Some merger simulation techniques rely on fewer assumptions than these simple approaches whilst also providing predictions as to the scale of price effects. Unfortunately the trade off for relying on fewer assumptions is that these techniques have considerably larger data requirements and invoke complex econometric techniques to estimate the necessary parameters. Consequently, the use of these techniques is still controversial and they do not tend to provide a workable alternative to classic empirical techniques in the majority of cases.

26. **BIAC submits that Competition Authorities should be wary of the spurious precision created by simplistic models which seek to estimate the pricing effects of mergers as they rely on a number of untested assumptions.**

2.6. **Ignoring or downplaying the many important factors that cannot be incorporated into UPP (dynamics, entry, supply-side responses)**

27. A principal shortcoming with UPP analysis is that it unduly focuses on a static model of competition and does not therefore accommodate other important factors which serve to constrain the behaviour of firms. Such factors can often provide much more important influences on the impact that mergers have on competition than the immediate static impact on price incentives.

28. For example, expansion, entry and brand repositioning allow competitors to win business by supplying a substitute good to the merging parties’ products, and therefore may prevent price increases following a merger, either at all or at least to a substantial degree. These factors are entirely ignored by the UPP framework, meaning that this approach

---

6 The Lerner condition states that there is an inverse relationship between the percentage gross margins (defined as the mark up over variable costs) which firms make and the elasticity of demand which they face. Where firms have high margins it is argued that this implies they face inelastic demand as, if they did not, it would be profit maximising to lower prices (they would gain many more sales at a slightly lower margin).
necessarily overstates the potential for anti-competitive merger effects, particularly in dynamic and innovative markets.

29. **BLAC submits that it is simply not possible to develop a meaningful measure of incentives to raise prices without a detailed analysis of supply-side responses and Competition Authorities should be particularly wary of applying these techniques in highly dynamic markets.**

3. **Developments in the analysis of vertical and conglomerate mergers**

   **3.1. Introduction**

30. The introduction of the EU Non Horizontal Merger Guidelines and a number of high-profile merger decisions including Google/DoubleClick, Nokia/Navteq, and TomTom/Tele Atlas have made an important contribution in aligning EU and US approaches on non-horizonal mergers, especially with respect to vertical mergers.

31. However, whilst the developments are largely positive, there remain some concerns within the business community that the approach to analysing vertical mergers leads to an unnecessary burden on merging firms. These issues are discussed in detail below.

   **3.2. Economic analysis – e.g. vertical arithmetic – can play an important role in ensuring a more robust framework for such cases**

32. At the EU and US level, Competition Authorities have increasingly employed ‘vertical arithmetic’ in order to assess potential for anti-competitive effects to arise from vertical mergers.\(^7\) The primary benefit of the vertical arithmetic approach is that it provides a clearly structured framework for analysing the costs and benefits associated with a foreclosure strategy. It also helps to stress the range of factors which must necessarily hold for foreclosure to be credible and profitable. In this regard the implementation of vertical arithmetic should be viewed as an important development in the assessment of vertical mergers as it tends to ensure that factors which may serve to dismiss foreclosure concerns are not overlooked by Competition Authorities.

33. One criticism that may be levelled at this formalistic approach is that it is often tricky to implement because it relies on a number of factors which are hard to measure.\(^8\) However, rather than serving to undermine the usefulness of this approach, these difficulties simply highlight the general uncertainties that surround necessarily speculative theories of harm relating to foreclosure in vertical mergers. Consequently, where Competition Authorities lack evidence to prove conclusively that foreclosure is likely using vertical arithmetic, the right conclusion should be that foreclosure is unlikely, and not that the economic tools used to analyse these effects are inappropriate.

\(^7\) See for example, Case No COMP/M.4942 NOKIA / NAVTEQ.

\(^8\) For example the benefits accruing from an input foreclosure strategy will generally depend on the cross price elasticities of demand in downstream markets, and the extent to which a refusal to supply would increase costs (which in turn depends on the supply side responses of upstream rivals and possibly on economies of scale).
34. **BIAC submits that vertical arithmetic introduces a rigorous structure to the assessment of vertical cases and ensures that factors which may serve to dismiss foreclosure concerns are not overlooked by Competition Authorities.**

3.3. **Critical that businesses have confidence to engage in vertical mergers that create synergies and pursue competitive advantage**

35. In the large majority of cases, non horizontal mergers are very unlikely to lead to anti-competitive outcomes. For example, where merging firms do not benefit from market power in overlapping markets, there is no prospect that anti-competitive foreclosure would arise as a result of a merger. Moreover, it is widely accepted that vertical mergers can lead to synergies and pricing efficiencies as they bring together parts of the supply chain that can be viewed in economic terms as largely ‘complementary’.

36. This point is now generally accepted by Competition Authorities, but the reality is that the safe harbours applied to vertical cases remain excessively cautious. The purpose of providing market share thresholds is (or should be) to provide a clear one-tailed test; if neither of the merging parties has a market share in excess of the threshold then all competition concerns can be readily dismissed without the need for detailed investigations. In the view of BIAC, given the fact that significant market power has rarely been established below 40 per cent, a higher market share threshold than, say, the 30 per cent threshold applied by the European Commission is justified.

37. **BIAC submits that to avoid creating unnecessary legal uncertainty for merging Parties, Competition Authorities should seek to set safe harbour thresholds at a level where only mergers with a realistic prospect of resulting in anti-competitive foreclosure would be captured.**

3.4. **Authorities must guard against incentives for third parties and lobby groups to use competition arguments as a cloak for special interest pleading or protectionism**

38. When analysing a merger it is often crucial for Competition Authorities to gather evidence from a wide range of sources in order to best analyse its likely effects on consumers and (where foreclosure concerns are alleged) competitors. However, in circumstances where evidence is presented by third parties such as competitors or lobby groups with a special interest in the outcome of an investigation, it is crucial that Competition Authorities have regard to those interests and do not seek to burden merging firms unduly as a result of potentially spurious allegations.

39. In the case of vertical mergers, it is relatively easy for competitors to induce Competition Authorities to engage in in-depth investigations by presenting evidence or concerns pertaining to potential foreclosure issues. The result is that merging firms are burdened with substantially greater deadweight legal and business costs as well as delays associated with regulatory clearance in spite of the fact that the general presumption is that such mergers are likely to be pro-competitive or competitively benign.

40. **BIAC submits that Competition Authorities must seek to apply appropriate weightings to evidence presented by third parties with a special interest in the outcome**
of an investigation, and to be at least as sceptical of their motivations as they are of the arguments of the merging parties.

4. The treatment of efficiencies in merger cases

4.1. Introduction

41. It is well recognised that both horizontal and vertical mergers can lead to efficiencies that may feed through to customers in the form of lower prices. However, a concern remains that merger efficiencies are not given the prominence they deserve as a credible defence in merger assessment and there is little evidence of a willingness on the part of Competition Authorities to engage fully on these issues. To the contrary, where efficiencies have formed a key element of merger decisions they have actually tended to form part of a theory of harm rather than a reason for clearing deals.

4.2. The efficiency offence

42. It is well documented that, as well as offering a reason for clearing mergers, efficiencies have sometimes been invoked by Competition Authorities as a potential reason to prohibit transactions.\(^9\) This is particularly relevant in the context of conglomerate and vertical mergers, where it has been argued that a merger between suppliers of complementary products could make the merged firm ‘too efficient’, and that this in turn could result in commercial damage and hence to the foreclosure of competitors.

43. The use of such ‘efficiency offences’ is generally considered to be highly controversial. The reason for this is that anti competitive effects arising from the foreclosure of competitors is speculative and any consumer harm will necessarily occur at some potentially distant point in the future after competition has been foreclosed from the market in its entirety. Against this, these theories of harm are predicated on the existence of considerable efficiencies which enable the merging parties to compete more aggressively. Taking these factors into account, a Competition Authority should have to be certain of concrete anti-competitive effects to outweigh the considerable benefits to consumers implied by these theories of harm – a scenario which is rarely satisfied in the context of foreclosure analysis. Hence these theories of harm rarely have a strong foundation in practice.

44. BIAC submits that theories of harm relying on pro competitive efficiencies are highly speculative and rarely justified in practice.

4.3. Limited concept of static variable cost efficiencies

45. When analysing mergers, it is crucial for Competition Authorities to consider the full range of potential efficiencies which may give rise to lower prices and quality improvements for customers. Traditionally, in the context of horizontal mergers, the discussion of merger efficiencies has tended to focus on static variable cost efficiencies. The rationale for this approach is that, where a merger leads to fixed cost savings, but no reduction in variable costs, it is unlikely to reduce prices since economic theory generally suggests that variable costs, 

---

\(^9\) See for example Case No COMP/M.2220 General Electric/Honeywell.
rather than fixed costs, primarily affect pricing decisions. Further, efficiencies relating to more dynamic elements of competition (such as innovation) can be hard to assess and evidence in practice.

46. However, there are many instances when fixed costs will have a direct effect on the prices. For example, where firms compete on non-price factors requiring substantial investments that are treated as fixed costs for accounting purposes, it is still very likely that these costs will affect pricing decisions (i.e. they will be viewed as a marginal cost of increasing output and sales over the medium term) and savings in these overheads may well lead to price reductions and/or to the ability to offer make new sales propositions profitable.\(^\text{10}\) Where it can be shown that fixed costs are intrinsically linked to final prices in this way, Competition Authorities should be open to evidence of countervailing efficiencies arising from fixed cost reductions in merger cases.

47. Moreover, whilst difficult to measure, it is perfectly credible that many mergers will give rise to material ‘dynamic’ efficiencies which will significantly benefit consumers. For example, where a merger enables firms to invest more in research and development as a result then there may be considerable benefits to customers in the long term as a result. Over time, the benefits of dynamic efficiencies will typically substantially outweigh those of static efficiencies and they should not therefore be dismissed by Competition Authorities where reasonable evidence is presented to support their existence.

48. **BIAC submits that Competition Authorities should be open to evidence of the full range of efficiencies that can result from mergers.**

4.4. **Quantification of efficiency effects – low priority and high burden of proof applied**

49. Merger cases in which efficiency defences have been accepted remain few and far between, reflecting the difficulties which firms face in persuading Competition Authorities of these benefits. This reflects the fact that merging firms face an unduly high burden of proof when attempting to support efficiency claims in practice.

50. The difficulties facing merging parties in evidencing merger efficiencies are particularly pertinent in the context of non-horizontal mergers as these types of mergers generally offer significant scope to create efficiencies (see section 3.3). In this context, it is still questionable whether the assessment of efficiencies is given sufficient prominence by Competition Authorities. For example in recent non-horizontal cases considered by the EC such as Nokia/Navteq, and TomTom/Tele Atlas, the Commission ultimately declined to reach a conclusion on the efficiencies proposals (although it was noted that apparent efficiencies ‘strengthened’ its conclusions that neither merger gave rise to anticompetitive effects).

51. **BIAC submits that merging firms continue to face prohibitively high evidentiary standards in supporting efficiencies claims.**

---

\(^{10}\) A simple example of this comes from luxury goods such as designer handbags. Marketing costs associated with maintaining brand image are very likely to be viewed as being fundamentally linked with sales volumes and will therefore be considered when prices are being set.
4.5. **Important that emerging competition authorities are also encouraged to follow this approach, avoiding the temptation to use competition laws to effect industrial policy objectives**

52. From an economics perspective, it is perfectly reasonable for Government agencies to pursue a potentially diverse range of industrial policy objectives. Moreover, in some circumstances industrial concerns may be considered to ‘trump’ competition issues, resulting in mergers being allowed that may otherwise have been blocked or remedied on purely competition grounds. An example of this can be taken from the UK regime where the merger between Lloyds and HBOS was cleared on special interest grounds because it was considered crucial to the continued functioning of financial markets, and despite the existence of competition concerns.\(^{11}\)

53. However, Competition Authorities must guard against the use of competition instruments such as the merger control regime as a way to covertly effect other industrial policy objectives such as the protection of national champions from international control. Such practices risk undermining the credibility of merger control regimes and considerably increase the uncertainty for firms considering potential mergers and acquisitions. In turn this can lead to reduction in the number of efficiency enhancing mergers taking place.

54. **BIAC submits that Competition Authorities should not use competition instruments as a way of covertly effecting wider industrial policy objectives.**

---